Supreme Court, U. S.
FILED
SEP 22 1978
MICHAEL RODAK, JR., CLERK

No. 77-1824

In the Supreme Court of the United States

OCTOBER TERM, 1978

M. SETH HORNE AND MAURINE D. HORNE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 1-40) are reported at 59 T.C. 319. The opinion of the court of appeals (Pet. App. 42-49) is reported at 523 F. 2d 1363.

JURISDICTION

The judgment of the court of appeals was entered on September 30, 1975, and its order denying rehearing was entered on March 27, 1978 (Pet. App. 50). The petition for a writ of certiorari was filed on June 23, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether payments petitioner made in satisfaction of his obligation as indemnitor of the debts of a corporation, of which he was president and majority shareholder, gave rise to debts that had not become wholly worthless so as to be nondeductible under Section 166(d) of the Internal Revenue Code of 1954.

STATUTES INVOLVED

The pertinent provisions of Sections 165 and 166 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth at Pet. 3-4.

STATEMENT

Petitioner[1] was the principal partner in a real estate development firm which owned all the outstanding shares of James Stewart and Co., Inc. (COINC). COINC had two wholly-owned subsidiaries, James Stewart Company (CO) and James Stewart Corporation (CORP). All three corporations were engaged in construction and general contracting work. In the conduct of their business they were required to furnish performance bonds and New Amsterdam Casualty Company, a bonding company, issued bonds to the three companies. Each corporation agreed to cross-indemnify New Amsterdam against any losses New Amsterdam might incur as surety for the other two corporations (Pet. App. 3-9, 42-43).

In 1960, New Amsterdam was informed that CO would not be able to complete its existing construction contracts and that COINC and CORP lacked sufficient funds to

[1]"Petitioner" refers to M. Seth Horne. Maurine D. Horne is a party because she filed a joint return with her husband for the years in issue.

perform their obligations as indemnitors under the cross-indemnity agreements. New Amsterdam thereupon requested that petitioner and his partners assume personal indemnity obligations for any loss incurred on the three corporations' bonds. Although the other partners refused to assume personal liability, petitioner acceded to prevent the loss of his investment in COINC and damage to his credit reputation. The partnership was dissolved and the corporations were reorganized, with the assets of COINC and CORP transferred to CO. Petitioner received all of the stock of CO in exchange for his shares of COINC (Pet. App. 9-10, 43).

Contemporaneously with the reorganization of the three corporations on January 20, 1961, petitioner entered into an indemnity agreement with New Amsterdam and CO, pursuant to which he became jointly and severally liable with CO for any losses incurred by New Amsterdam as surety for CO. Subsequently, New Amsterdam made payments on behalf of CO, and petitioner, pursuant to the indemnity agreement, paid New Amsterdam $237,434 in 1966, $121,749 in 1967, and $238,246 in 1968. CO treated half of the amounts paid by petitioner to the bonding company during 1966 through 1968 as paid-in capital, and the remaining half as an account payable to petitioner (Pet. App. 20, 44). CO subsequently repaid petitioner part of the amount treated by him as loans to CO (Pet. App. 43-44; Tr. 177).[2]

On his federal income tax returns for 1966, 1967, and 1968, petitioner deducted one-half of the amounts he paid to New Amsterdam as ordinary losses under Section 165. The amounts deducted by petitioner as losses were the

[2]"Tr." refers to the trial transcript.

portions (one-half of each payment) treated as paid-in capital (Pet. App. 20). During these same years, CO and its successor corporation had a net worth (excess of assets over liabilities) of more than $600,000; by 1971, its net worth was approximately $5 million (Pet. App. 24, 43-44).

On audit, the Commissioner of Internal Revenue disallowed the claimed deductions. The Commissioner determined that the payments represented additional contributions to the capital of the corporation, or, alternatively, that the sums paid gave rise to nonbusiness debts under Section 166(d) that had not become worthless during the years in issue (Pet. App. 24-25). The Tax Court held that the payments were debts but that they were not worthless and therefore not deductible because CO was financially able to repay petitioner during the years at issue (Pet. App. 39-40).

The court of appeals affirmed (Pet. App. 42-44). It stated: "In view of the tax court's determination that CO possessed the resources to reimburse [petitioner] during the period, we must conclude the obligations were not worthless and therefore no deduction is permitted" (Pet. App. 47).[3]

ARGUMENT

1. The decision below correctly held that petitioner's payments to the surety were not deductible. Petitioner seeks to deduct one-half of the payments as ordinary

[3]Both courts rejected petitioner's alternative arguments that the amounts paid to the surety were fully deductible as ordinary and necessary business expenses under Section 162 or as expenses incurred in the production of income under Section 212 (Pet. App. 31-32, 39, 46). Petitioner no longer relies upon Section 212 in support of his claimed deduction.

losses under Section 165(c)(2) or as ordinary and necessary business expenses under Section 162. But petitioner and his corporation treated the amounts in question as paid-in capital contributions to the corporation (Pet. App. 20).[4] As such, they were not deductible, in accordance with the rule set forth in Section 263. A shareholder's contribution of capital to his corporation is not deductible but increases the basis of his stock. While a capital contribution may result in a subsequent loss upon disposition, corporate liquidation or worthlessness of the stock, none of these occurrences took place here. To the contrary, the record establishes that at all times during the years in question (1966-1968), petitioner's corporation had a net worth of more than $600,000, and by 1971, its net worth was approximately $5 million (Pet. App. 24, 44). Accordingly, the corporation was a thriving going concern. Thus, even on the assumption that the payments were not contributions to capital, petitioner is not entitled to an ordinary deduction under Section 165 because he sustained no loss during the tax years in issue. See Treasury Regulations, Section 1.165-1(a) and (b) Cf. *Burns* v. *Commissioner*, 31 F. 2d 399, 400-401 (C.A. 5); *Perlman* v. *Commissioner*, 252 F. 2d 890 (C.A. 2); *Bavinger* v. *Commissioner*, 22 B.T.A 1239.[5]

[4]The remaining half of the amounts paid by petitioner to the surety was treated as an account payable to him, at least part of which the corporation subsequently repaid (Pet. App. 20, 44; Tr. 177).

[5]Although the Tax Court rejected (Pet. App. 28-29) the government's argument that the payments were part of petitioner's basis in the CO stock, it did so on the ground that petitioner's indemnification obligation was not part of the consideration that he paid for the acquisition of the stock from his two former partners. In this respect, the Tax Court overlooked (Pet. App. 28-29 n. 11) the government's additional contention that the payments represented a subsequent contribution by petitioner to the capital of the corporation.

2. Alternatively, even if petitioner's payments are viewed as a loan to the corporation,[6] rather than as capital contributions, the courts below correctly concluded that petitioner was not entitled to a bad debt deduction under Section 166 because there was no evidence that the debts became worthless during the years in issue, a factual finding no longer challenged by petitioner. Since both courts found (Pet. App. 40, 47) that the corporation had the resources to reimburse petitioner at all times during the years in issue, there is no basis for a bad debt deduction.

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[6]The courts below treated the payments as deductible, if at all, as a nonbusiness bad debt under Section 166, rather than Section 165, on the basis of *Putnam* v. *Commissioner*, 352 U.S. 82. There, the Court held that payments made by a taxpayer-shareholder as guarantor of loans to his corporation were deductible only as nonbusiness bad debts under Section 166(d) and could not be deducted under Section 165(c)(2) as losses incurred in a transaction entered into for profit.

Petitioner asserts (Pet. 15-16) that the rule of *Putnam* does not apply because as indemnitor rather than a guarantor, he was not subrogated to the rights of the lender against the debtor-corporation. Although *Putnam* turned in part upon the taxpayer's right of subrogation, the Court in *Putnam* also emphasized that in order to give Section 166(d) its intended effect, it was essential that all taxpayers who incur losses in providing financing for their corporations should receive the same tax treatment, regardless of the particular method of financing used. On the basis of this rationale, the court below concluded, in accordance with *Martin* v. *Commissioner*, 52 T.C. 140, 144-146, affirmed *per curiam*, 424 F. 2d 1368 (C.A. 9), certiorari denied, 400 U.S. 902, and *Stratmore* v. *United States*, 420 F. 2d 461, 464-465 (C.A. 3), certiorari denied, 398 U.S. 951, that the statutory scheme mandates a common tax treatment for all losses suffered by a shareholder in providing his corporation with financial assistance, and that different tax results should not turn on the technical right of subrogation. See also *United States* v. *Hoffman*, 423 F. 2d 1217 (C.A. 9); *United States* v. *Generes*, 405 U.S. 93. (And see H. Rep. No 94-658, 94th Cong., 1st Sess., p. 177 (1975), describing Congress' understanding of the present law, prior to the repeal of Section 166(f) of the Code, as follows: "* * * in the case of a

3. *Stahl* v. *United States*, 441 F. 2d 999 (C.A. D.C.), and *Lutz* v. *Commissioner*, 282 F. 2d 614 (C.A. 5), upon which petitioner relies (Pet. 12, 16), are not to the contrary. In *Stahl*, the taxpayer loaned securities to a securities firm so that the firm could satisfy certain SEC requirements. When the securities were subsequently sold by the firm prior to its bankruptcy, the taxpayer suffered a loss and the only question was whether it was fully deductible under Section 165(c), or deductible only as a nonbusiness bad debt under Section 166. The court held that it was deductible under Section 165, on the ground that the transaction constituted a bailment rather than a "debt." Unlike petitioner, the taxpayer in *Stahl* unquestionably sustained a loss during the year in issue. Moreover, the court in *Stahl* carefully distinguished *Putnam* (and its subsequent application in *Stratmore* v. *United States*, *supra*, and *United States* v. *Hoffman*, *supra*) on the ground that the taxpayer in *Stahl* was not a shareholder in the corporation to which she gave her securities and, therefore, the transaction did not represent "financing provided to a corporation by a taxpayer-stockholder to protect his pre-existing investment" (441 F. 2d at 1003).

Lutz is likewise distinguishable. There, the court upheld the taxpayer's claim to a business expense deduction

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guarantor of a corporation obligation [a term which includes indemnitors for purposes of Section 166(f)], any payment under the guaranty agreement must be deducted (if at all) as a nonbusiness bad debt, regardless of whether there is any right of subrogation, unless the guaranty was made pursuant to the taxpayer's trade or business.") Since the post-*Putnam* cases have not regarded the state law of subrogation as material for federal tax purposes (see also *Siple* v. *Commissioner*, 54 T.C. 1), and petitioner sustained no loss, there is no basis for petitioner's assertion (Pet. 11-14) that the decision below conflicts with *Howell* v. *Commissioner*, 69 F. 2d 447 (C.A. 8), a case decided 22 years prior to this Court's decision in *Putnam*.

under Section 162 for his voluntary payment of debts of certain controlled farm corporations which he had paid to protect his individual business as an agriculture produce broker. Here, on the other hand, the record shows (Pet. App. 4, 19) that petitioner did not engage in any business activities on an individual basis separate from that of the partnership or corporation. Rather, the advances were made primarily to protect his investment in the corporation. *Whipple* v. *Commissioner,* 373 U.S. 193; *United States* v. *Generes,* 405 U.S. 93.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1978.

DOJ-1978-09